

## FAIR POLITICAL PRACTICES COMMISSION

### Memorandum

**To:** Chairman Getman, Commissioners Downey, Knox and Swanson

**From:** Kenneth L. Glick, Counsel  
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**Subject:** Adoption of Amendments to Regulation 18705.1  
Materiality Standard: Economic Interests in Business Entities

**Date:** November 20, 2002

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### I. OVERVIEW

When a business entity is an economic interest to a public official (regulation 18703.1) and a governmental decision will have a reasonably foreseeable financial effect on that business entity, the standards under which that financial effect will be deemed material are found at regulation 18705.1. When the business entity is indirectly involved in the governmental decision, the applicable materiality standard, described at regulation 18705.1, subdivision (c), is a sliding scale, under which a business entity of comparatively larger size may incur a greater financial effect, before that effect is deemed material. For this purpose, the regulation contains four tiers for sizing an indirectly-involved business entity. These tiers are:

- (1) listed among the Fortune 500,
- (2) listed, **or meeting the financial criteria to be listed** [emphasis added], on the New York Stock Exchange (“NYSE”),
- (3) listed, **or meeting the financial criteria to be listed** [emphasis added], on the American Stock Exchange (“AMEX”) or NASDAQ, and
- (4) entities not meeting any of the foregoing.

The emphasized language “**or meeting the financial criteria to be listed**” is referred to as the alternative ranking standard.<sup>1</sup>

The proposed amendments to regulation 18705.1 are narrow in scope and do not change the existing categories for ranking the size of a business entity or the financial thresholds associated with those categories. Instead, the proposed amendments respond to public concerns with this alternative ranking standard. These concerns are generally threefold: discerning which of an exchange’s listing criteria are the financial listing criteria, obtaining access to a business entity’s financial information, and applying the

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<sup>1</sup> The August 4, 2002, pre-notice memorandum regarding regulation 18705.1 contains background information on the alternative ranking standard.

financial information to determine whether an exchange's financial listing criteria have been met.

The purpose of this alternative standard is to apply the same materiality standard to both publicly-traded and private business entities of the same or similar size. Thus, the proposed amendments are directed to the alternative ranking standard in the second and third tiers and to the small investment exception, where this alternative ranking standard is also employed. In addition, two new terms are defined and subdivision (d) of the regulation is amended to reflect these definitions.

## **II. PRE-NOTICE DISCUSSION**

At its September 5, 2002, meeting, the Commission considered and decided to notice for public comment proposed amendments to regulation 18705.1 (attached at Appendix 1) to resolve public concerns with the alternative ranking standard. Generally, these amendments will substitute a new alternative ranking standard that uses earnings before taxes and net income in place of the existing language, "financial criteria for listing." The specific tentative changes selected by the Commission were:

First, the alternative ranking standard will now be defined in the regulation and will be a threshold amount of "earnings before taxes" or, with respect to AMEX/NASDAQ, "net income".

Second, the thresholds under the new alternative standard will be the public official's election of either (1) a dollar amount specified in the regulation, which amount is based on the relevant exchange's present listing thresholds, or (2) such other superseding amount used as a listing threshold at the time the decision is made. Option (2) maintains the intent of the present regulation to have the same materiality standard for both publicly-traded and private business entities of the same or similar size.

Third, "earnings before taxes" and "net income" will be defined at subdivision (d) of regulation 18705.1 and clarification added in that subdivision that these accounting terms are the same as, or not inconsistent with, terms used in Generally Accepted Accounting Principles and Generally Accepted auditing Standards.

Fourth, the new alternative ranking standard will be substituted in place of the existing alternative ranking standard, with respect to the small investor exception applicable to directly-involved business entities.

Finally, a COMMENT is added identifying the internet address for the Securities and Exchange Commission's public database of business entity financial information, and the internet addresses to obtain current listing thresholds for the New York and American Stock Exchanges, and NASDAQ.

### III. PUBLIC COMMENT

As of the date of this memorandum, no written comments on these proposed amendments to regulation 18705.1 have been received. Similarly, no members of the public attended or participated by telephone for the purpose of commenting on this regulation when an Interested Persons meeting was held on July 12, 2002.

### IV. PROPOSED AMENDMENTS

The proposed amendments substitute threshold amounts of earnings before taxes (NYSE) and either earnings before taxes or net income (AMEX/NASDAQ) in place of the current alternative ranking standard. In addition, an election is given allowing use of other dollar amounts as thresholds, as determined from time-to-time by the relevant exchange. In this manner, the thresholds in the regulation are self-adjusting to reflect then current listing thresholds used by the exchanges to determine listing eligibility. Both earnings before taxes and net income will be defined in regulation 18705.1(d) and clarification will be added that these terms are the same as, or not inconsistent with, terms used in Generally Accepted Accounting Principles and Generally Accepted Auditing Standards. These amendments are depicted in the chart below<sup>2</sup>:

Size of Business Entity	Related Exchange	New Alternative Ranking Standard
Tier 2	NYSE	Earnings before taxes of no less than either (i) \$2.5 million or (ii) such other amount described at Rule 102.01C of the NYSE listed company manual, or any superseding rule of the NYSE.
Tier 3	AMEX, NASDAQ	(A) Earnings before taxes of no less than either (i) \$750,000 or (ii) such other amount described under initial listing standard 1 of section 101(a) of the rules of the AMEX, or any superseding rule of the AMEX; or (B) (i) net income of no less than \$500,000 or (ii) such other amount described in the minimum financial requirements for continued listing on the NASDAQ SmallCap Market.

This new alternative ranking standard will also be substituted where the present alternative ranking standard is used in the small investor exception. (Regulation 18705.1, subdivision (b)(2).) This exception allows materiality to be tested under the indirectly-involved standards when a public official's economic interest in a directly-involved business entity is attributable solely to an investment of \$25,000 or less. Finally, a COMMENT is added identifying the internet address for the Securities and Exchange

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<sup>2</sup> The benefit of the proposed amendments to the public is readily apparent when this chart summarizing the new alternative ranking standard is compared to the three pages of charts, shown at Appendix 2, that are necessary in order to describe the existing alternative ranking standard.

Commission's public database of business entity financial information, and the internet addresses to obtain current listing thresholds for the New York Stock Exchange, American Stock Exchange, and NASDAQ.

#### **IV. STAFF RECOMMENDATION**

Staff recommends that the Commission approve for adoption the proposed amendments to regulation 18705.1, without change. Staff also recommends that the Commission maintain on its website the currently-posted internet "links" allowing public access to the SEC, NYSE, AMEX and NASDAQ websites described in the COMMENT that will be added to regulation 18705.1.

Attachments: Appendix 1 - Proposed Amendments to Regulation  
Appendix 2 - Existing Alternate Ranking Standard  
(Financial Criteria for Listing on Exchanges)